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## Tax Alert

For more information, please contact

### Charles Chan

Chairman and CEO

Tel: +852 2894 6818

Email: charles.chan@crowehorwath.hk

### Wilson Tam

Executive Director

Tel: +852 2894 6679

Email: wilson.tam@crowehorwath.hk

### Albert Cheung

Executive Director

Tel: +852 2894 6830

Email: albert.cheung@crowehorwath.hk

### George Lam

Associate Director

Tel: +852 2894 6656

Email: george.lam@crowehorwath.hk

### Mary Ho

Associate Director

Tel: +852 2894 6161

Email: mary.wfho@crowehorwath.hk

### C Yuen

Senior Advisor

Tel: +852 2894 6812

Email: chung.yuen@crowehorwath.hk

## Hong Kong Launched Consultation Paper on Implementation of Measures by OECD to Counter Base Erosion and Profit Shifting (“BEPS”) of Enterprises

On 26 October 2016, the Hong Kong SAR Government published a consultation paper on implementation of the actions (“consultation paper”) by the Organisation for Economic Cooperation and Development (“OECD”) to counter Base Erosion and Profit Shifting (“BEPS”) of enterprises, with a series of proposed measures for a two-month public consultation. The Hong Kong Government aims to introduce the relevant tax amendment bills into the Legislative Council in mid-2017 after consultation. Following the passage of the bill, the law will be enforced.

### Background

In 2013, G20 and OECD launched the BEPS Action Plan. As of 31 October 2016, a total of 87 countries and tax jurisdictions have joined the inclusive framework for implementation of countering BEPS package, and Hong Kong is a member of the framework. As an international financial center and a responsible member of the international community, the Hong Kong Government had made known to OECD in June 2016 its commitment to countering BEPS package and its implementation.

The Hong Kong Government’s commitment for implementation of countering BEPS package includes implementing the four minimum standards below and the related measures.

- Countering harmful tax practices;
- Preventing treaty abuse;
- Imposing country-by-country (CbC) reporting requirement; and

- Improving the cross-border dispute resolution regime.

In view of the extensive scope covered by OECD’s BEPS package and the very tight implementation timetable, the Hong Kong Government has set a priority for various tasks to establish the necessary regulatory framework so as to meet the relevant requirements of OECD. The tasks include:

- Transfer pricing rules;
- Spontaneous exchange of; information on tax rulings;
- Transfer pricing documentation and CbC report;
- The cross-border dispute resolution mechanism; and
- The Multilateral Instrument.

In this article, we shall focus on discussing one of the above top priority tasks that has significant impact on Hong Kong enterprises and require immediate action, i.e. transfer pricing documentation and CbC report.

## (A) Measures to Implement the Transfer Pricing Documentation and CbC Reporting proposed in the consultation paper

### 1. Transfer pricing regulatory regime

The consultation paper states that “transfer pricing refers to the setting of prices for transactions of goods, services and intangible property between associated enterprises. For tax purposes, transfer pricing rules determine the conditions under which transactions between these associated enterprises, including prices, resulting in fair allocation of profits. OECD is committed to ensure that the transfer pricing outcomes are aligned with value creation, this will help avoid manipulations by multinational enterprises (MNEs) which shift profits to low tax jurisdictions.”

The consultation paper proposes to provide for the fundamental transfer pricing rule which requests the intra-group transactions be priced based the arm's length principle and should be consistent with the relevant rules and guidelines of OECD. In addition, enterprises operating in Hong Kong should comply with the transfer pricing documentation requirements.

### 2. OECD requirements for transfer pricing documentation and CbC reporting

OECD has developed a three-tier standardised approach which requires enterprises to submit relevant information to the tax authority for assessment of transfer pricing risks. The three-tier standardised approach, based on BEPS Action 13, has the following requirements:

#### Tier 1 – a Master file:

this mainly provides a high-level overview information of the group of enterprises, including organizational structure, description of global business(es), intangibles, intercompany financial activities, and financial and tax positions;

#### Tier 2 – a Local file :

this mainly provides detailed transactional transfer pricing and financial information specific to the enterprise in each tax jurisdiction, including a description of the local entity, material category of controlled transactions and related information (e.g. amount involved, identification of associated enterprises involved), detailed comparability and functional analysis, transfer pricing analysis (including selected comparable uncontrolled transactions analysis) and conclusion;

#### Tier 3 – a CbC report :

this sets out the amounts of revenue, profits/loss and tax paid as well as certain indicators of economic activity such as number of employees, stated capital, retained earnings and tangible assets (excluding cash) for each tax jurisdiction in which a MNE group operates. And the main business activities of the relevant entities should be specified according to their tax jurisdictions.

### 3. Measures proposed under the consultation paper for implementing transfer pricing documentation and CbC reporting

Measures proposed under the consultation paper for the implementation of transfer pricing documentation and CbC reporting by enterprises are as follows:

#### 3.1 Master file and local file

- (1) All enterprises that carry on trades or businesses in Hong Kong and engage in transactions with associated enterprises<sup>1</sup> should be required to prepare the master and local files, except for enterprises under (2) below:

(2) Enterprises that satisfy any two of the following three conditions are not required to prepare the master and local files:

- a) Total annual revenue not more than HK\$100 million;
- b) Total assets not more than HK\$100 million; and
- c) No more than 100 employees.

### 3.2 CbC Reporting

According to OECD requirements, MNEs with annual consolidated group revenue equal to or exceeding EUR750 million should file CbC reports. The consultation paper has proposed to use the equivalent amount in local currency as of January 2015, i.e. HK\$ 6.8 billion as the benchmark. If the annual gross income of MNEs amounts to HK\$6.8 billion or more, a CbC report must be submitted.

### 4. The related parties involved

The consultation paper proposes to establish the basic rules for transfer pricing in accordance with the arm's length principle, and such rules will apply to cases where the affected persons are associated, i.e. one affected person is directly or indirectly participating in the management, control or capital of the other, or a third person is participating in the same of both affected persons. It is also applicable to the transactions between different parts of an enterprise, such as between the head office and a permanent establishment.

### 5. When should transfer pricing documentation be prepared

The consultation paper proposes that an enterprise should prepare the master file and the local file for each financial year and retain the files for at least seven years after the end of the relevant year.

<sup>1</sup> Such enterprises include the permanent establishment of overseas companies in Hong Kong.

With regard to CbC report, a MNE is required to submit the report within 12 months from the last day of its fiscal year. According to the timetable for the implementation of countering BEPS package, time is of the utmost urgency. For CbC reports, the OECD requirements should be implemented by fiscal year beginning on or after 1 January 2016 and reviewed globally by 2020. Taking into account of the fact that Hong Kong must enact local legislation to implement the relevant provisions, the Hong Kong Government plans to require the relevant MNEs to collect information in 2018 and submit the first batch of CbC reports to the Inland Revenue Department ("IRD") in 2019.

## (B) Crowe Horwath's Observations

Looking at the Hong Kong Government's consultation paper on the implementation of countering BEPS package, we can see that the Hong Kong Government has indeed made a great deal of determination. On the one hand, the Government has to ensure that Hong Kong is able to meet the international standards of the BEPS Inclusive Framework and, on the other hand, not to compromise the simple tax regime of Hong Kong. Based on the Hong Kong Government's international commitment to the OECD, we believe that the proposed transfer pricing documentation and CbC reporting requirements in the consultation paper will become imperative tax measures (Individual clause may be supplemented and/or amended after consultation). With regard to the impact of the relevant measures on Hong Kong enterprises, our Crowe Horwath have the following observations:

### **1. Some of the measures proposed in the consultation paper could be further refined in order to be fair and reasonable**

The consultation period for the consultation paper will end on 31

December 2016. Some of the measures proposed in the consultation paper may be revised or refined upon finalization.

Based on our initial observations and discussions with our clients, we are of the view that some of the issues in the consultation paper are worth discussing. For example:

#### **1) Safe harbour rules for preparing the master and local files:**

The consultation paper suggests that the preparation of the master file and local file may be exempted as long as the enterprise meets any two of the three conditions (please see 3.1 (2) above). In this regard, some issues seem worthy for further discussion, for example:

- a) For the provision for total annual revenue of an enterprise, it does not state how much the related party transactions will be accounted for in the amount of HK\$100 million. In this regard, should an explanation for the above be provided?
- b) Should the thresholds for preparing master file and local file be different from each other?
- c) Related party transactions include various types of transactions, such as trading of tangible assets, transfer of intangible assets, provision of services, and financing/ leasing. Should the thresholds for preparing master file and local file for different category/ type of transactions be different from each other?

#### **2) How to reasonably impose a tax penalty:**

The consultation paper proposes that "making tax returns with incorrect information on transfer pricing willfully with intent to evade tax" may constitute a criminal offense (please see (B) 2 (1) below). In this regard, we consider that it is important to define clearly what is meant by "making tax returns with incorrect information on transfer pricing". Since the scope of transfer pricing information can be broad, the management and implementation of tax compliance can be facilitated if which transfer pricing information

should be regarded as necessary information in the tax returns, and what constitutes "incorrect information on transfer pricing" can be clearly defined.

### **2. If the enterprise violates the transfer pricing rules, the cost could be tremendous**

For this subject, we can analyze from the following points:

#### **(1) Tax penalty provisions**

First, the consultation paper proposes that, without reasonable excuse, failure to comply with the relevant transfer pricing rules is subject to a tax fine upon conviction. In serious circumstances (such as making tax returns with incorrect information on transfer pricing willfully with intent to evade tax), these may constitute criminal offence. The maximum fine is an amount trebling the tax undercharged plus HK\$50,000 and imprisonment for 3 years.

From this we can see that the Hong Kong Government has strong determination to mandate enterprises to comply with OECD requirements and transfer pricing rules after enactment, and very strict enforcement is anticipated.

Obviously, if the related party of an enterprise paid less tax in another tax jurisdiction due to failure to comply with the transfer pricing regulations, that related party will also be penalised in another tax jurisdiction.

#### **(2) Enterprise may face the risk of being subjected to transfer pricing investigation**

If a Hong Kong enterprise fails to prepare transfer pricing documentation even though it is required to do so, it will likely attract the attention of the IRD and thus be subjected to transfer pricing investigation.

Such practice of tax authorities has been evidenced in the Mainland of China and many other tax jurisdictions.

### (3) The risks faced by enterprises and their directors will also be greatly increased

Once the transfer pricing measures are passed by the Legislative Council and becomes law after going through specified procedures, the preparation of the transfer pricing documentation will become a mandatory requirement for relevant enterprises. Enterprises and its board of directors should take the responsibility of its corporate governance and tax compliance. If an enterprise should prepare a transfer pricing documentation but it does not prepare such document, the firm and its board of directors may be challenged by the regulatory body(ies) or its auditor.

### (4) Impact on the operation of the enterprise

For enterprises that conduct cross-border related party transactions, such transactions are usually undertaken with associated enterprises situated in other tax jurisdictions. In the context of countering BEPS package, tax authorities in different jurisdictions will scrutinize the enterprises under their governance, to assess whether the transfer pricing of related party transactions is reasonable, whether each associated enterprise along the supply chain obtains a fair allocation of profit that aligns with its value creation. In the event of a misalignment, the tax authority in charge would initiate transfer pricing investigation on the associated enterprise in the local jurisdiction, and demand profit adjustment.

Since Hong Kong is a low-tax jurisdiction, Hong Kong enterprises

need to establish and maintain a sound, reasonable and defensible transfer pricing policy to substantiate the company's profit level in both form and substance.

Therefore, it is particularly important for Hong Kong enterprises to prepare the master files and local files for proper and correct record of their transfer pricing policies.

### 3. When should enterprises begin to prepare transfer pricing documentation

According to the consultation paper, the Hong Kong Government plans to require the relevant MNEs to collect information and prepare CbC reports in 2018, and the first batch of CbC reports should be submitted to the IRD in 2019.

In the case of transfer pricing master files and local files, the consultation paper does not specify when an enterprise that meets the requirements for preparation of transfer pricing documentation should complete the transfer pricing documentation when it submits the 2017 tax return in 2018. Since the master file and local file of a fiscal year should be completed after the end of that fiscal year, the master file and the local file are the basis for the preparation of the CbC report. Based on a prudent estimate, enterprises that meet the preparation requirement may need to get their 2017/18 master files and local files prepared by 2018.

### 4. Preparing well for the new changes

(1) The master file contains macro information in respect of transfer pricing of an enterprise (such as the Group's overall transfer pricing policy), whereas the local file contains

detailed transfer pricing information of transactions, arrangements and their analyses. In order to comply with OECD transfer pricing documentation requirements, enterprises are generally required to provide transfer pricing benchmarking analysis by using a database containing information of global public companies. Following OECD transfer pricing guidelines and local transfer pricing regulations or guidelines to prepare transfer pricing documentation, this procedure usually takes quite some time to complete.

(2) Experience shows that enterprises should prepare transfer pricing documentation as early as possible as an effective way to prevent from and mitigate transfer pricing risk. In fact, the process of preparing documentation is a self-examination and enhancement process for enterprises. If a company waits until the last minute to prepare the documentation, there will be no time to improve or enhance the transfer pricing policy even when weaknesses are identified. In this regard, enterprises that broadly meet the requirements under the consultation paper to prepare transfer pricing documentation may start preparing the documentation for 2016/17 immediately after end of 2016/17. If the transfer pricing documentation shows that the transfer pricing policy or transaction of a group or a subsidiary is in compliance with the relevant requirements of transfer pricing guidelines of OECD and Hong Kong, compliance can be enhanced. However, if weaknesses are identified, improvements can also be made in the year 2017, with a view to meeting the relevant requirements of OECD and Hong Kong soon thereafter. We recommend that enterprises should consult their transfer pricing experts or consultants to get prepared as soon as possible.